Ohio Consumers' Counsel

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The Honorable John D. Dingell
Ranking Member, House Commerce Committee
2328 Rayburn House Office Building
Washington, D.C. 20515-6115

Dear Representative Dingell:

I am writing in response to your letter and questions dated July 15 to Larry Frimerman of my staff regarding the recent events affecting electricity markets, their impact on consumers, and the advisability of proposed federal restructuring legislation. Our responses to your questions are attached.

The Ohio Consumers' Counsel shares your concerns about the recent volatility in electricity markets. These events point out that we still have much to learn in order to develop the mechanisms, the industry structure, and the consumer and competitive protections necessary to establish an effectively competitive national retail electricity market. While the specific causes are difficult to pinpoint, these price spikes and supply shortages underscore the potential for the exercise of market power to inflate prices to consumers if specific changes in market structure or regulation are not adopted as a part of any restructuring legislation.

The Ohio Consumers' Counsel opposes Congressional legislation that imposes a date certain for states to adopt retail competition. If Congress considers any comprehensive electric restructuring legislation, it must provide sufficient consumer protections and create an industry structure that allows the net benefits of competition to flow to small consumers. This would include providing regulatory authority to take any action necessary to prevent or correct the presence and exercise of utility market power.

If you have any questions, or would like to discuss this matter, please call Larry Frimerman at (614) 466-9557. We again appreciate the opportunity to serve you and the Congress.

Sincerely,

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RESPONSES OF THE OHIO CONSUMERS' COUNSEL TO QUESTIONS OF CONGRESSMAN JOHN D. DINGELL

1. *QUESTION:* Please outline your understanding of the course of events leading to supply curtailments and price surges in electricity markets during the week of June 22, including any gaps in your understanding of relevant factors.

   RESPONSE: OCC's understanding of the referenced events during the week of June 22 derives solely from media reports and other anecdotal evidence. First, the problems occurred on a regional basis. Several utilities throughout the Midwest were short on generating capacity because of planned and unplanned outages. These outages included the long-term closures of several base-load nuclear facilities (e.g. Illinois Power Company's Clinton facility; Commonwealth Edison's LaSalle facility; American Electric Power's Cook facility), as well as closures related to the regular plant maintenance schedules of numerous utilities.

   In addition, the region was beset by unplanned outages. Several of these unplanned outages were weather-related. FirstEnergy's Avon Lake (Unit 9) was closed due to a lightning strike on a transformer. FirstEnergy's Davis-Besse nuclear facility closed when a tornado damaged the unit's transmission switchyard. Mechanical problems caused outages at several other generating plants (e.g. American Electric Power's Muskingum facility). American Electric Power (AEP) and FirstEnergy for example, both had approximately 20% of their generating capacity out-of-service at the time in question.

   The region's decline in available capacity occurred during a summer when forecasted reserves were already low. ECAR, the regional reliability council covering all or part of eight states (including Ohio), had previously noted that the region's reserve margin would be approximately 12 percent this summer. Obviously, ECAR's forecasted reserve margin did not reflect the unplanned outages cited earlier.

   Other factors may, or may not, have contributed to the supply shortages. One such factor, for example, could be the implementation of new, untested transmission loading relief (TLR) procedures by the North American Electric Reliability Council (or NERC). The implementation of TLR procedures may have constrained the region's transmission system. Such constraints, if present, would have exacerbated the supply problem.

   Correspondingly, the region experienced a surge in demand due to hot, humid weather. The hotter-than-normal weather did *not* establish any new temperature records or any new system peak demands. Other factors, such as certain contract terms, may have contributed to the surge in demand. For example, some contracts provide for significant penalties if a customer did not accept delivery of the capacity specified in the contract.

   Given this explanation, OCC believes that several areas require additional study. For example, one should clarify the role that TLR procedures played in the June shortages, as well as what role, if any, was played by any other factors (e.g. contract terms which induced panic buying).

2. *QUESTION:* Are you considering initiating, or have you already begun, an inquiry into these events? If so, please describe the purposes, scope, and timetable for completion of any such proceeding.

RESPONSE: OCC is not conducting its own inquiry into the June shortages. The agency does expect, however, to participate in any investigation conducted by Ohio authorities.

3. *QUESTION:* Are you seeking or participating in any such proceeding undertaken by another organization?

RESPONSE: OCC is participating in a Public Utilities Commission of Ohio (PUCO) inquiry as a part of Case No. 98-978-EL-UNC.

4. *QUESTION:* Do you consider the price spikes and supply shortages in the Midwest during June to be a one-time event, or might they recur? Are you concerned about the remainder of the summer, and what are the factors affecting near-term market stability? If you think a recurrence of market turbulence is possible, do you believe changes in market structure or regulation may be needed?

RESPONSE: The circumstances that resulted in the shortages could be easily replicated. As noted earlier, there were no record temperatures or system peak demands set during the period in question. Indeed, the shortages occurred at a time when demand throughout the Midwest was artificially depressed by the General Motors strike. Obviously, the probability exists that a period of even higher temperatures could coincide with another series of planned and unplanned generation outages. In short, the possibility exists that a weather-related surge in demand could coincide with generation constraints. Given the uncertainty regarding the subsequent surge in wholesale market prices, however, one cannot forecast (with any certainty) as to whether a similar surge in prices would occur again.

Changes in market structure will likely not affect the near term situation. However, market structure and market power issues could prove to be quite significant in the future if there are further increases in market concentration, or market power, or if the strategic exercise of market manipulation increases through mergers, or through transmission and generation acquisitions. It is thus important that any changes in market structure or regulation limit or prevent the abuse of market power.

5. *QUESTION:* Are you aware of any complaints alleging market manipulation or conflicts of interest involving regulated utilities or other market participants?

RESPONSE: OCC has no first hand knowledge of market manipulation. We have read published reports rumoring market manipulation. For example, the agency notes Steel Dynamics' complaint regarding the actions of American Electric Power Co. Allegedly, the various affiliates of AEP curtailed their respective interruptible industrial customers and asked all of their customers to voluntarily conserve. AEP then made substantial revenues by selling the power in the wholesale power market .

6. *QUESTION:* What if any direct or indirect effects on consumers resulted, or may yet result from the price and supply disruptions in the Midwest in late June? Are residential customers more or less vulnerable than industrial customers, in terms of price increases and reliability to supply?

   RESPONSE: All customers were asked to voluntarily conserve electricity. Some reductions were forced, particularly among industrial interruptible customers. There were some power outages due to storms. Residential customers of investor-owned utilities in Ohio were protected because of regulatory caps on rates and/or prices. Residential customers may be at greater risk during the intermediate or long term because they have less flexibility to shed demand, choose other suppliers, or to acquire supplemental resources.

7. *QUESTION:* What if any effects did this market volatility have on public power entities and their customers?

   RESPONSE: We know of no public power entities in Ohio that did not receive power, although we have been told of sharply increased costs related to purchased power. However, the extent to which consumers are affected has not yet been determined.

8. *QUESTION:* Do you foresee any lessons to be drawn from this experience for state or federal legislators deliberating the merits of electric restructuring legislation? How would more widespread retail competition affect market stability in the future, and how would residential consumers be affected? Are markets ready to make a smooth transition to full retail competition now, and should Congress pass legislation to compel states to adopt competition?

   RESPONSE: As mentioned in Response #4, it is very possible for certain key market participants with market power to engage in the kind of strategic behavior which manifests itself in the form of creating price spikes and short-term supply shortages. This is especially true if the generation market, as expected, becomes much more concentrated than even today.

   For example, a Duke Energy official recently predicted that the generation market would contain 5-6 major generation companies in the very near future. If this occurs, a major generator could identify strategic opportunities and select a vulnerable time to take certain units off line, changing transmission flows, balances, or even creating shortages. The company could then sell wholesale power into the grid at a premium, and extract monopoly revenues from wholesale and retail customers. Such a circumstance is not hard to imagine as the power (and potentially, the transmission business under a Transco approach) supply business becomes more concentrated.

Ineffective competition will result in additional market anomalies. Competition must be effective to reduce market failures and to provide opportunities for benefits of competition to flow to residential and other small consumers. Yet, effective competition does not happen automatically or without structuring a transition from a monopoly market structure to a competitive structure. The concerns over the impact of market domination on consumer bills and competition heighten the need to minimize market power of incumbents.

If incumbent utilities are not subject to sufficient residual regulatory controls and are also relieved of their obligation to serve at the lowest reasonable cost, small consumers are likely to be worse off under electric restructuring.

While there are more than a dozen states that have approved retail competition, there are only a handful of states in which customers can actually choose their provider. Thus far, the experience has been less than sterling, and the benefits to small customers of electric competition thus far are speculative at best in most states.

While we support competition where it can be structured in a way that provides some likelihood that residential consumers are net beneficiaries, we are concerned that a premature move to widespread or national retail competition without proper market power curbs could prove disastrous. At best, it could provide uneven cost savings for some customers in certain markets, while other markets see price increases. At worst, we could have deregulated oligopolies or monopolies extracting monopoly rents with no hope of near-term competition. If anything, the price spikes and shortages have alerted consumers of the potential risks inherent in moving from a complete monopoly to a competitive market, while the incentives to maintain market power are still present. It is clear that market safeguards are not in place, and that the industry does not have a sufficient framework to safeguard small consumers from significant risks in the future.

As such, it is not appropriate at this time for the Congress to enact legislation that would compel the states to adopt a retail competitive market framework by a date certain.